Cornerstone of the Board

LESSONS ON CREATING OR REBUILDING A BOARD

SpencerStuart

About Spencer Stuart

Spencer Stuart is one of the world's leading executive search consulting firms. Privately held since 1956, Spencer Stuart applies its extensive knowledge of industries, functions and talent to advise select clients — ranging from major multinationals to emerging companies to nonprofit organizations — and address their leadership requirements. Through 51 offices in 27 countries and a broad range of practice groups, Spencer Stuart consultants focus on senior-level executive search, board director appointments, succession planning and in-depth senior executive management assessments.

The premier firm for board counsel and recruitment, Spencer Stuart conducts well over half of all director assignments handled through executive search. For more than 25 years, our Board Services Practice has helped boards around the world identify and recruit independent directors and provided advice to chairmen, chief executive officers and nominating committees on important governance issues. In the past year alone, we have conducted more than 400 director searches. We are the firm of choice for both leading multinationals and smaller organizations, conducting more than one-third of our assignments for companies with revenues under $1 billion.

In addition to our work with clients, Spencer Stuart has long played an active role in corporate governance by exploring — both on our own and with other prestigious institutions — key concerns of boards and innovative solutions to the challenges facing them. Publishing the *Spencer Stuart Board Index*, now in its 24th edition, is just one of our many ongoing efforts:

- We participate in the Directors' Institute hosted by The Conference Board and serve as an advisory board member of The Conference Board's Global Corporate Governance Research Center.
- Each year, we sponsor and participate in several director education programs including the Annual Boardroom Summit, jointly sponsored by the New York Stock Exchange and *Corporate Board Member* magazine; the Corporate Governance Conference at Northwestern University's Kellogg School of Management; and Corporate Governance Fresh Insights and Best Practices for Directors, in partnership with the Wharton School at the University of Pennsylvania.
- We also sponsor and participate in another annual premier event, The Chairman's Forum at the Yale School of Management's Millstein Center for Corporate Governance, a peer organization of independent chairmen on corporate boards.
- Together with Agenda, a leading corporate governance publisher, we co-sponsor the Outstanding Directors Awards.

Corporate boards tend to be very stable organizations, generally with little director turnover from year to year. However, there are scenarios in which boards are created essentially from scratch or must be aggressively reinvented — when a company is taken public, spun off from a parent or rebuilt after bankruptcy or a crisis.

These situations provide the rare opportunity to shape the composition of the board to reflect the direction, challenges and opportunities of the new or reinvented company. These new boards should be consciously and carefully constructed with the particular focus of creating a board capable of guiding the new entity.

Based on our significant experience helping companies build or rebuild their boards, we have a definite point of view on how to proceed. Looking across a number of these engagements with clients, we have documented what we believe to be the best practices in the following blueprint for building a board.

> Start with strategy
> Secure board leaders
> Create a matrix of desired board skills
> Consider the board culture and organization
> Understand the special considerations for different scenarios

UNDERSTAND THE SPECIAL CIRCUMSTANCES

While the fundamentals of building a new board are similar, it is helpful to understand the unique characteristics and issues associated with spinoffs or companies preparing for an IPO or undergoing reorganization, which are highlighted in the next few pages.

SPINOFF

Maintaining an element of continuity with the parent company may be an important consideration. This is a way of ensuring institutional memory and can be achieved by bringing at least one director from the parent company onto the board. Bridging the old and the new can be a useful role for an elder statesman director who is nearing retirement. Tapping an individual who is knowledgeable about the parent, as well as the logic and business of the spinoff, for the new board can help it get off to a good start. At the end of his or her term, the director may cycle off the board, opening a space for a new director. This allows the board to identify a need that directors may not have predicted when forming the board.

Everything flows from the strategy

Building a new board should begin with a thoughtful, detailed process and upfront planning that starts before the actual search for director candidates begins. Regardless of the specific situation — a reorganization, a spinoff or an IPO — the foundation of this process is a thorough understanding of the future strategy of the company.

In all of these situations, understanding the strategy enables the next logical step: determining the set of talents, backgrounds and knowledge needed on the board to evaluate and propel the strategy.

Start with strong board leadership

While board leadership is always an important consideration, it is even more crucial when constructing a new board to ensure it — and the company — get off to a strong start. The first step is to evaluate the board's leadership requirements.

An important early consideration is whether the chairman and CEO roles should be separate or combined with a single individual. It is common for the chair and CEO roles to be split in new boards because of the diverse responsibilities associated with establishing the new entity — from operating responsibilities, to working with a vast array of internal and external constituencies, to getting the board off to a strong start when there is no corporate or governance structure or legacy on which to rely.

BANKRUPTCY OR CRISIS

In bankrupt, distressed or financially vulnerable companies, recruiting new directors may be necessary to regain credibility with key investors, customers and, sometimes, with regulators. In these situations, the board may be overseeing a restructuring of the company and may need to evaluate and potentially replace the CEO. For these reasons, it can be important to have a strong nonexecutive chairman to lead the board as it assesses the strength and suitability of management for the restructured business and ensures that restructuring milestones are met. A nonexecutive chairman also serves as an independent voice to stakeholders. Given the complex strategic, operational, financial and legal aspects of restructuring, there is a need for directors with significant financial acumen and industry-specific knowledge and those who have the desire and time to dedicate to the board's work.

In the case of a spinoff, the CEO often is a senior executive from the parent company who has been chosen to lead the new company. He or she may have no prior experience as the CEO of a public company, with all of its attendant governance requirements and other new demands beyond those on a divisional leader. Similarly, in an IPO, a CEO is typically in place already, but may not have public company experience. In a reorganization, boards frequently have a nonexecutive chairman who can serve as an independent and credible voice to shareholders and other stakeholders as the company emerges from the crisis. In a restructuring, the first job of the board often is to determine if the company has the right CEO. The chairman should have the time and skills to lead a CEO search succession process and possibly serve as an interim CEO. If the chairman and CEO roles will eventually be combined, the board must have a lead independent director.

The nonexecutive chairman or lead director. Begin by determining all the characteristics the company will need in the board and the CEO in order of priority. Evaluate which of those traits the CEO brings and identify the complementary traits that would be valuable in the nonexecutive chair or lead director.

Look for an anchor or magnet figure to serve in the role of lead director or nonexecutive chair, as this person can be a powerful force in attracting other valuable directors. Indeed, this individual may be charged partially with selling the opportunity. Recruiting a strong, independent leader for the board who has both the experience and the credibility — whether dealing with employee groups or investors — will be a huge asset in building an effective board. For these reasons, and because of the significant time commitment, nonexecutive chairs or lead directors of new boards are often retired CEOs or chairmen of other public companies.

INITIAL PUBLIC OFFERING

A company preparing for a public offering typically recruits directors with significant public company experience, especially former CFOs or others with public company finance expertise. In situations in which the CEO does not have public company experience, many boards have established the role of nonexecutive chair, who can provide an experienced voice to the CEO and, by managing the board, allow the new CEO to focus on running the company.

A nonexecutive chair or lead director's duties include:

> Preparing the agenda for and chairing board meetings
> Organizing the board to do its work, for example, helping to determine who chairs which committees
> Leading the governance process
> Leading the CEO and board evaluation processes
> Spearheading CEO succession planning
> Leading the board in executive sessions

When the chair and CEO roles are combined, then the lead independent director will provide important support to the CEO/chair and the rest of the board in carrying out these duties.

Key committee chairmen. Another leadership position that is a priority to fill is the audit committee chair. As the responsibilities of audit committees have expanded, the importance of recruiting a capable audit committee chair cannot be overstated. Given the weighty and complex duties demanded of this position, new boards especially require an individual with financial expertise and public company board experience, as well as the time to devote to this role. Once this position is anchored, it will be easier to recruit others to serve on the audit committee. Individuals subsequently recruited for the audit committee will have more confidence that the audit committee will be run well, and will be less concerned that serving on the board will expose them to significant risk.

For many boards, recruiting a skilled compensation committee chairman also has become a priority because of the intense scrutiny on executive compensation.

BOARD-BUILDING CHECKLIST: RECRUIT STRONG BOARD LEADERS

- ☐ Secure the best board leadership, as early as possible.
- ☐ Consider best practices regarding the CEO and chair roles, and determine which model — one that combines the CEO and chair responsibilities or one that separates the roles — is most relevant to your new board.
- ☐ Determine the qualities and experience most critical in a lead director or nonexecutive chair for your new board.
- ☐ Make it a priority to recruit strong committee chairs, starting with audit and compensation committees.

Developing a skills matrix

An effective strategy to employ in assembling the rest of the board is to think in terms of a skills matrix. Each square of the matrix reflects a "must have" or "nice to have" skill or experience, such as prior board experience, industry expertise, specific board committee experience (audit or compensation, for example) or specialized expertise in areas such as international business, marketing, technology or finance. Once developed, the idea is to fill in the matrix with priority requirements when recruiting directors.

Matrices and priorities will, of course, vary depending on the nature of the business, its strategy and current situation. For example, in a post-bankruptcy reorganization, it may be valuable for the board to have someone who has been through a restructuring or a former banker who can consider possible transactions. In an IPO situation, a former CFO with significant public company experience or a former investment banker with extensive experience in financing may be in demand.

One important category in the matrix is diversity. Rather than being considered an end in itself, diversity is increasingly considered an underlying dimension or criterion when potential directors are sought for skills or experience. More and more, boards recognize that including diverse perspectives on the board — in the areas of age, gender, race and ethnicity and, in some cases, geographic knowledge — is important. Boards are not normally embracing diversity to be politically correct or because of outside pressure, but because it expands their views on issues, options and solutions. It's diversity of thought that is important and an advantage in board discussions and deliberations. That comes from having directors who don't all come from the same mold, but from different backgrounds and experiences. Age is important because the board wants to have appropriate turnover and not lose all board members in the same year when they hit a mandatory retirement age.

The matrix also should include consideration of the board's committee requirements. In addition to the audit committee, the board needs knowledgeable independent directors to lead and serve as members of the compensation and nomination and governance committees. For a compensation committee chair, the desired background might include a public company CEO with a great deal of board experience, or someone who has previously served as a compensation committee chair, and others with expertise in human resources or compensation. Whoever is selected, the individual must be up-to-date on compensation issues and trends, as well as a decision maker who can lead the board in creating an appropriate and explainable compensation model. The nominating committee chair should be experienced in board governance and have a thorough understanding of best practices and evolving trends in corporate governance.

BOARD-BUILDING CHECKLIST: DEVELOP A SKILLS MATRIX

- ☐ Think holistically about director recruitment as opposed to one-off recruitments.
- ☐ Develop a matrix of the overall skills and experience required for the board. Use the skills matrix to ensure the bases are covered when recruiting.
- ☐ Think about the various diversity dimensions that would be valuable to include on the new board, including geographic representation.
- ☐ Outline specific requirements for key committee chairs.
- ☐ Consider specific constituencies that will be important to the board and recruit directors who are familiar with them.

Lay the groundwork for a cohesive board team

One of the characteristics of an effective board is that directors bring varied perspectives to boardroom discussions, yet work well together. They know why they have been recruited and what is expected of them, both as individuals and as a team.

Recruiting for cultural fit. Teamwork is critical to the effective working of a board. Those leading the search will be able to get a good feel for a candidate's fit in the course of conversations with a prospective director. The first thing to test with director candidates is how they think about governance. Candidates should have a healthy and contemporary view on governance, neither diminishing its importance nor allowing compliance to overshadow the board's broader role in strategy and succession planning. Look for directors who are able to question, discuss, listen, express an opinion and articulate differences in a constructive way. The best directors are willing to make the tough decisions and be accountable, while being a team player.

Getting off to the right start. Building a cohesive board culture is vitally important. These efforts are particularly important when a board is starting from scratch and has no culture, tradition or even relationships on which to build. Many new boards start the culture-building process by having directors regularly meet over dinner before each board meeting. An informal dinner or similar social gathering allows directors to bond before they begin to work as a group.

In addition, some boards have found it invaluable to have an orientation on important business issues or governance-related topics before the first formal board meeting, when they must deal with actual board issues. Convening directors informally for training helps the board to get off to a fast start once their formal responsibilities begin.

Of course, not every board has the luxury of time to gradually acclimate directors — particularly in a reorganization. But, if possible, the cohesion that develops among directors will pay dividends down the road when the board has to work as a team on difficult issues and under time pressures.

BOARD-BUILDING CHECKLIST: PAY ATTENTION TO CULTURAL FIT

- ☐ Define the desired board culture and personal director traits to ensure congruency.
- ☐ Plan kick-off events for new directors, including social dinners and a board orientation, that will model and reinforce the culture.
- ☐ Plan ongoing training and information sessions with the board to ensure all directors receive the company knowledge they need to effectively carry out their duties as board members.

Organizing the board to accomplish its work

An important task early on is to determine the governance structure and parameters for the new board and the potential impact on director recruitment: board size, committees, frequency and location of board and committee meetings, and director compensation. In some cases, these may be built upon the existing policies of the parent company or the current board, as in the case of a reorganization or spinoff.

Adopting progressive governance and compensation programs may be viewed as a signal of things to come, and thus a way of attracting first-class directors. It can be helpful to develop a recruiting manual to describe the basics of the company, including the key businesses and personnel, corporate structure and locations, relevant company history and the governance policies that will apply.

Board size. We recommend starting small — both in terms of the number of directors and the number of committees — when creating a new board. Ideally, the board should be small enough to have high-quality, active discussions and large enough to be able to populate the committees. It is easier to build up the board than to whittle down once people and structures are already in place. Over time, gaps in the board's skills and committee needs will become evident, and needed modifications can be addressed. So, what is the magic number? From our experience and the experience of those who have led new boards, a good place to start is with a core group of seven to nine directors and with the three core committees — audit, compensation and nominating.

Compensation. Since a newly formed board must compete for and retain the best directors, it generally approaches director compensation in a systematic way. That may mean working with an outside compensation consultant to establish benchmarks by company size and industry to ensure director compensation falls within accepted norms. In the case of restructurings, it may require providing a piece of the upside if the company succeeds.

Directors may spend several months in limbo between the time they are recruited and when they become official members of a functioning board. How do company leaders determine a fair way to handle this limbo period from a compensation perspective, and, further, how do they determine overall compensation for the new board? While compensation is not primarily what attracts top-notch directors to boards, how compensation is handled does speak volumes about how a company values its directors as well as the time and effort they must expend.

To cover the interim period — between signing on and the first board meeting — some boards provide a monthly stipend plus board meeting fees. Others provide a lump sum retainer for directors of the new board, of a sufficient size to solidify their agreement to join the board as well as to fairly compensate them for an estimated three to six days of their time for the six-month interim period.

BOARD-BUILDING CHECKLIST: ORGANIZATION AND PROCESS

- ☐ Determine governance parameters for the new board and the potential impact on director recruitment: board size, committees, the frequency and location of board and committee meetings, and director compensation.
- ☐ Consider building upon the policies of the parent company or current board.
- ☐ Assemble the principles to use in director recruitment.

QUESTIONS AND GUIDELINES FOR BUILDING OR REBUILDING A BOARD

While there is not one right formula to follow when building or rebuilding a board, there are practices that correlate with getting off to a good start as well as with long-term success. Consider the following questions and guidelines to help ensure your board addresses and resolves key issues early on:

BOARD LEADERSHIP

> Will the new board combine or separate the CEO and chair roles?
> If combined, what responsibilities should the lead director have?
> What skills and expertise should the chair or lead director bring? To what extent should these complement the CEO?

GOVERNANCE CONSIDERATIONS

What governance parameters will the new board adopt? For example:

> Board size: How many directors will serve initially, based on the number of committees planned and the other board responsibilities?
> Committees: Which committees will be established from the outset? What is the process for considering the creation of additional committees?
> Meetings: How frequently will the board and its committees be meeting? When and where will board and committee meetings be held?
> Compensation: How will directors be compensated — retainer, equity, meeting fees, etc. — both in the short term and longer term?
> What are the implications for director recruitment (e.g., number of directors, skill mix, etc.)?

CONTINUITY

> How many directors from the parent or original company's board will be deployed to the new board initially and why?
> How will this process be managed to best ensure continuity?
> What implications will this have for director selection and committee assignments?

DIRECTOR EXPERTISE AND BACKGROUND

Skills and experiences

> What skills and experiences will be needed on the board to help the company succeed and deliver value to shareholders?
> What should the director skills matrix include?
> What experience is needed by the nonexecutive chair or lead director based on the company's situation and the skill-sets of the CEO?

Committee expertise

> What steps will the board take to ensure committee chairs have relevant domain expertise?

> What skills are critical for the audit chair?

> What skills are critical for the compensation committee chair?

Boardroom culture

> What personal traits are important in directors and how will these contribute to the overall culture of the board?

> What steps will the board take to develop an effective and collegial culture?

> How will new board members be assessed to determine "fit" with the desired culture?

Board orientation

> What steps will be taken to ensure all directors receive the materials and training they need to effectively carry out their duties as board members?

About the authors

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Chairman of Spencer Stuart U.S., **Thomas J. Neff** is based in New York and has been with the firm since 1976. He managed the worldwide firm from 1979 to 1987. He focuses on CEO and board of director consulting and searches. He has conducted more than 150 CEO searches and more than 350 board searches. Tom founded the Board Services Practice in the U.S. as well as the firm's U.S. advisory board of prominent CEOs. He previously served as leader of the firm's professional practices committee for 10 years.

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